

Stock-Based Compensation

As permitted by FASB Statement No. 123, Accounting for Stock-Based Compensation ("Statement 123"), the Company has elected to follow Accounting Principles Board Opinion No. 25, Accounting for Stock Issued to Employees ("APB 25") and related interpretations in accounting for its employee stock-based compensation. Under APB 25, no compensation expense is recognized at the time of option grant if the exercise price of the employee stock option is fixed and equals or exceeds the fair market value of the underlying common stock on the date of grant, and the number of shares to be issued pursuant to the exercise of such option are known and fixed at the grant date. As more fully described in Note 8, the Company's outstanding stock options are not considered fixed options under APB 25. The Company accounts for non-employee stock-based compensation in accordance with Statement 123.

Segment Reporting

In 1998, the Company adopted FASB Statement No. 131, Disclosures About Segments of an Enterprise and Related Information ("Statement 131"). Statement 131 uses a management approach to report financial and descriptive information about an entity's operating segments. Operating segments are revenue-producing components of an enterprise for which separate financial information is produced internally for the entity's chief operating decision maker. Under this definition, the Company operated within a single segment for all periods presented.

Start-up Activities

In 1999, the Company adopted Statement of Position 98-5, Reporting on the Costs of Start-Up Activities, which requires costs of start-up activities to be expensed as incurred. This statement had no effect on the Company's results of operations or financial position, because the Company expensed such costs in prior years.

Recently Issued Accounting Pronouncements

In June 1998, the Financial Accounting Standards Board issued Statement No. 133 ("Statement 133"), Accounting for Derivative Instruments and Hedging Activities, which will require the Company to recognize all derivatives on the balance sheet at fair value. The Company will be required to adopt Statement 133, as amended by Statement No. 137 which defers the effective date, as of January 1, 2001. Derivatives that are not hedges must be adjusted to fair value through income. If the derivative is a hedge, depending on the nature of the hedge, changes in the fair value of derivatives will either be offset against the change in fair value of the hedged assets, liabilities, or firm commitments through earnings or recognized in other comprehensive income until the hedged item is recognized in earnings. The ineffective portion of a derivative's change in fair value will be immediately recognized in earnings. The Company has not yet determined what the effect of Statement 133 will be on the earnings and financial position of the Company.

In December 1999, the Securities and Exchange Commission issued Staff Accounting Bulletin No. 101 ("SAB 101"), Revenue Recognition in Financial Statements. SAB 101 provides additional guidance in applying generally accepted accounting

47

principles to revenue recognition in financial statements. In 1999 and previous years, the Company recognized installation revenue upon completion of the installation. Effective January 1, 2000, in accordance with the provisions of SAB 101, the Company will begin deferring installation revenue over the life of the contract. The Company estimates the effect of this change will be a reduction of revenue of approximately \$2.2 million and will be reported as a cumulative effect of a change in accounting principle in the Company's interim unaudited consolidated financial statements for the period ended March 31, 2000.

Reclassifications

Certain reclassifications have been made to the 1997 and 1998 consolidated financial statements to conform with the 1999 presentation.

3. NETWORKS AND EQUIPMENT

Networks and equipment are comprised of the following:

	DECEMBER 31	
	1998	1999
	(in thousands)	
Fiber optic systems.....	\$ 99,502	\$ 164,985
Telecommunications equipment.....	115,769	421,718
Furniture and fixtures.....	7,340	21,397
Leasehold improvements.....	1,177	1,811
Construction-in-progress.....	11,770	66,380
	235,558	676,291
Less accumulated depreciation.....	(10,668)	(36,967)
	<u>\$ 224,890</u>	<u>\$ 639,324</u>

Costs capitalized during the development of the Company's networks include amounts incurred related to network engineering, design and construction and capitalized interest. Capitalized interest related to the construction of the networks during the years ended December 31, 1997, 1998 and 1999 amounted to, \$854,000, \$5,133,000 and \$6,635,000, respectively.

For the years ended December 31, 1997, 1998 and 1999, depreciation expense was \$2,122,000, \$8,284,000 and \$27,723,000, respectively.

4. INTANGIBLE ASSETS

Intangible assets are comprised of the following:

	DECEMBER 31	
	1998	1999
	(in thousands)	
Franchise costs.....	\$ 1,690	\$ 2,015
Authorizations and rights-of-ways.....	1,455	2,052
Building access agreements and other.....	480	637
Other.....	582	401
	4,207	5,105
Less accumulated amortization.....	(1,378)	(1,503)
	<u>\$ 2,829</u>	<u>\$ 3,602</u>

48

5. ACCRUED EXPENSES

Accrued expenses are comprised of the following:

	DECEMBER 31	
	1998	1999
	(in thousands)	
Accrued compensation.....	\$4,436	\$11,423
Accrued costs related to financing activities...	380	7,316
Accrued interest payable.....	162	8,544

Accrued telecommunications costs.....	565	3,794
Other accrued expenses.....	3,644	5,970
	=====	=====
	\$9,187	\$37,047
	=====	=====

6. LONG-TERM DEBT

Senior Secured Credit Facility

On December 22, 1998, KMC Telecom, KMC Telecom II and KMC Telecom of Virginia (the "Subsidiary Borrowers"), refinanced and expanded the Amended and Restated Loan and Security Agreement (the "AT&T Facility") by entering into a Loan and Security Agreement (the "Senior Secured Credit Facility") with Newcourt Commercial Finance Corp. ("Newcourt"), First Union National Bank, General Electric Capital Corporation ("GECC") and Canadian Imperial Bank of Commerce (the "Creditors"). Under the Senior Secured Credit Facility, the Creditors agreed to lend the Subsidiary Borrowers up to an aggregate of \$250 million initially to be used for the construction and expansion of fiber optic telecommunications networks in certain markets and for payment of transaction fees and expenses and, subject to the attainment of certain financial conditions, for working capital and general corporate purposes.

The Senior Secured Credit Facility includes a \$175 million eight year revolving loan and a \$75 million eight and one half year term loan. At December 31, 1998 and 1999, an aggregate of \$41.4 and \$235.0 million, respectively, was outstanding under this facility.

As discussed further in Note 18, the Subsidiary Borrowers and KMC Telecom III amended, restated and combined the Senior Secured Credit Facility and the Lucent Loan and Security Agreement during the first quarter of 2000.

Borrowings under the Senior Secured Credit Facility bear interest payable at the Subsidiary Borrowers' option, at (a) the "Applicable Base Rate Margin" (which generally ranges from 1.75% to 3.25%) plus the greater of (i) the administrative agent's prime rate or (ii) the overnight federal funds rate plus .5% or (b) the "Applicable LIBOR Margin" (which generally ranges from 2.75% to 4.25%) plus LIBOR, as defined. Interest on borrowings outstanding at December 31, 1999 was based on both the base rate and LIBOR. The Subsidiary Borrowers were being charged a weighted-average interest rate of 9.38% and 10.26% at December 31, 1998 and 1999, respectively. The Subsidiary Borrowers must pay an annual commitment fee on the unused portion of the Senior Secured Credit Facility ranging from .75% to 1.25%.

The Senior Secured Credit Facility contains a number of affirmative and negative covenants including, among others, covenants restricting the ability of the Subsidiary Borrowers to consolidate or merge with any person, sell or lease assets not in the ordinary course of business, sell or enter into long term leases of dark fiber, redeem stock, pay dividends or make any other payments (including payments of principal or interest on loans) to KMC Holdings, create subsidiaries, transfer any permits or licenses, or incur additional indebtedness or act as guarantor for the debt of any person, subject to certain conditions.

The Subsidiary Borrowers are required to comply with certain financial tests and maintain certain financial ratios, including, among others, a ratio of total

debt to contributed capital, certain minimum revenues, maximum EBITDA losses and minimum EBITDA, maximum capital expenditures and minimum access lines, a maximum total leverage ratio, a minimum debt service coverage ratio, a minimum fixed charge coverage ratio and a maximum consolidated leverage ratio.

The Company obtained a waiver of compliance, for the quarter ended September 30, 1999, with certain financial covenants (related to revenue and EBITDA) contained in the Senior Secured Credit Facility. In addition, the EBITDA covenant was amended for the fourth quarter of 1999 through the fourth quarter of 2000 and the revenue covenant was amended for the fourth quarter of 1999 through the

first quarter of 2001 to less restrictive amounts. As of December 31, 1999, the Subsidiary Borrowers were in compliance with the covenants, as amended.

Lucent Loan and Security Agreement

KMC Telecom III entered into a Loan and Security Agreement (the "Lucent Facility") dated February 4, 1999 with Lucent Technologies Inc. ("Lucent") which provides for borrowings to be used to fund the acquisition of certain telecommunications equipment and related expenses. The Lucent Facility provides for an aggregate commitment of up to \$600 million, of which \$250 million is available at December 31, 1999 to purchase Lucent products. Further, up to an additional \$350 million will be available upon (a) additional lenders participating in the Lucent Facility and making commitments to make loans so that Lucent's aggregate commitment does not exceed \$250 million and (b) the Company satisfying certain other requirements, the most significant of which is KMC Holdings raising and contributing at least \$300 million in high yield debt or equity (other than disqualified stock) to KMC Telecom III. The Lucent Facility places certain restrictions upon KMC Telecom III's ability to purchase non-Lucent equipment with proceeds from such facility. At December 31, 1999, no amounts had been borrowed under the Lucent Facility.

As discussed further in Note 18, the Subsidiary Borrowers and KMC Telecom III amended, restated and combined the Senior Secured Credit Facility and the Lucent Loan and Security Agreement during the first quarter of 2000.

Interest on borrowings under the Lucent Facility is charged, at the option of KMC Telecom III, at a floating rate of LIBOR plus the "Applicable LIBOR Margin", or at an alternative base rate plus the "Applicable Base Rate Margin" (as defined). Such margins will be increased by 0.25% until KMC Telecom III and its subsidiaries have completed systems in fourteen markets.

The Lucent Facility contains a number of affirmative and negative covenants including, among others, covenants restricting the ability of KMC Telecom III to consolidate or merge with any person, sell or lease assets not in the ordinary course of business, sell or enter into any long-term leases of dark fiber, redeem stock, pay dividends or make any other payments (including payments of principal or interest on loans) to KMC Holdings, create subsidiaries, transfer any permits or licenses, or incur additional indebtedness or act as guarantor for the debt of any other person, subject to certain conditions.

KMC Telecom III is required to comply with certain financial tests and maintain certain financial ratios, including, among others, a ratio of total debt to contributed capital, certain minimum revenues, maximum EBITDA losses and minimum EBITDA, maximum capital expenditures and minimum access lines, a maximum total leverage ratio, a minimum debt service coverage ratio, a minimum fixed charge coverage ratio and a maximum consolidated leverage ratio.

Senior Discount Notes

On January 29, 1998, KMC Holdings sold 460,800 units, each unit consisting of a 12 1/2% senior discount note with a principal amount at maturity of \$1,000 due 2008 pursuant to the Senior Discount Note Indenture between KMC Holdings and the Chase Manhattan Bank, as trustee (the "Senior Discount Notes") and one warrant to purchase .21785 shares of Common Stock of KMC Holdings at an exercise price of \$.01 per share. The gross and net proceeds of the offering were approximately \$250 million and \$236.4 million, respectively. A substantial portion of the net proceeds of the offering have been loaned by KMC Holdings to its subsidiaries. On August 11, 1998, KMC Holdings exchanged the notes issued on January 29, 1998 for \$460.8 million aggregate principal amount at maturity of notes that had been registered under the Securities Act of 1933 (as used below and elsewhere herein, "Senior Discount Notes" includes the original notes and the exchange notes).

The Senior Discount Notes are unsecured, unsubordinated obligations of the Company and mature on February 15, 2008. The Senior Discount Notes were sold at

a substantial discount from their principal amount at maturity, and there will not be any payment of interest on the Senior Discount Notes prior to August 15,

2003. The Senior Discount Notes will fully accrete to face value on February 15, 2003. From and after February 15, 2003, the Senior Discount Notes will bear interest, which will be payable in cash, at the rate of 12.5% per annum on February 15 and August 15 of each year, commencing August 15, 2003. The Company is accreting the initial carrying value of the Senior Discount Notes to their aggregate face value over the term of the debt at its effective interest rate of 13.7%.

The Senior Discount Notes are redeemable, at the Company's option, in whole or in part, on or after February 15, 2003 and prior to maturity, at redemption prices equal to 106.25% of the aggregate principal amount at maturity, plus accrued and unpaid interest, if any, to the redemption date, declining to 100% of the aggregate principal amount at maturity, plus accrued and unpaid interest as of February 15, 2006.

In addition, at any time prior to April 15, 2000, the Company may redeem up to 35% of the aggregate principal amount at maturity of the Senior Discount Notes with the net proceeds from the sale of common equity at a redemption price of 112.50% of their accreted value on the redemption date.

The indebtedness evidenced by the Senior Discount Notes ranks pari passu in right of payment with all existing and future unsubordinated, unsecured indebtedness of KMC Holdings and senior in right of payment to all existing and future subordinated indebtedness of KMC Holdings. However, KMC Holdings is a holding company and the Senior Discount Notes are, therefore, effectively subordinated to all existing and future liabilities (including trade payables) of its subsidiaries.

Within 30 days of the occurrence of a Change of Control (as defined in the Senior Discount Note Indenture), the Company must offer to purchase for cash all Senior Discount Notes then outstanding at a purchase price equal to 101% of the accreted value thereof, plus accrued interest. The Company's ability to comply with this requirement is subject to certain restrictions contained in the Senior Secured Credit Facility.

The Senior Discount Note Indenture contains events of default, including, but not limited to, (i) defaults in the payment of principal, premium or interest, (ii) defaults in compliance with covenants contained in the Senior Discount Note Indenture, (iii) cross defaults on more than \$5 million of other indebtedness, (iv) failure to pay more than \$5 million of judgments that have not been stayed by appeal or otherwise and (v) the bankruptcy of KMC Holdings or certain of its subsidiaries.

The Senior Discount Note Indenture restricts, among other things, the ability of KMC Holdings to incur additional indebtedness, create liens, engage in sale-leaseback transactions, pay dividends or make distributions in respect of capital stock, make investments or certain other restricted payments, sell assets of KMC Holdings, redeem capital stock, issue or sell stock of restricted subsidiaries, enter into transactions with stockholders or affiliates or effect a consolidation or merger. The Senior Discount Note Indenture permits KMC Holdings' subsidiaries to be deemed unrestricted subsidiaries and, thus, not subject to the restrictions of the Senior Discount Note Indenture.

The Senior Discount Notes are "applicable high yield discount obligations" ("AHYDOs"), as defined in the Internal Revenue Code of 1986, as amended. Under the rules applicable to AHYDOs, a portion of the original issue discount ("OID") that accrues on the Senior Discount Notes will not be deductible by the Company at any time. Any remaining OID on the Senior Discount Notes will not be deductible by the Company until such OID is paid.

Senior Notes

On May 24, 1999, KMC Holdings issued \$275.0 million aggregate principal amount of 13 1/2% Senior Notes due 2009. On December 30, 1999, KMC Holdings exchanged the notes issued on May 24, 1999 for \$275.0 million aggregate principal amount of notes that had been registered under the Securities Act of 1933 (as used below and elsewhere herein, "Senior Notes" includes the original notes and the exchange notes). Interest on the Senior Notes is payable semi-annually in cash on May 15 and November 15 of each year, beginning November 15, 1999. A portion of the proceeds from the offering of the Senior Notes was used to purchase a portfolio of U.S. government securities that were pledged as security for the

first six interest payments on the Senior Notes.

The Senior Notes are redeemable, at the Company's option, in whole or in part, on or after May 15, 2004 and prior to maturity, at redemption prices equal to

51

106.75% of the aggregate principal amount at maturity, plus accrued and unpaid interest, if any, to the redemption date, declining to 100% of the aggregate principal amount at maturity, plus accrued and unpaid interest as of May 15, 2007.

In addition, at any time prior to May 15, 2002, the Company may redeem up to 35% of the aggregate principal amount at maturity of the Senior Notes with the net proceeds from the sale of common equity at a redemption price of 113.5% of the principal amount on such date plus accrued and unpaid interest. Upon a change of control (as defined in the Senior Note Indenture), the Company must offer to purchase for cash the Senior Notes at a purchase price equal to 101% of the principal amount, plus accrued interest. The Company's ability to comply with this requirement is subject to certain restrictions contained in the Senior Secured Credit Facility.

The Senior Notes were guaranteed by KMC Telecom Financing, Inc., a wholly-owned subsidiary. The Senior Notes are senior, unsecured unsubordinated obligations of KMC Holdings and rank pari passu in right of payment with all existing and future unsubordinated, unsecured indebtedness of KMC Holdings and senior in right of payment to all of existing and future subordinated indebtedness of KMC Holdings. However, KMC Holdings is a holding company and the Senior Notes are, therefore, effectively subordinated to all existing and future liabilities (including trade payables), of its subsidiaries.

The Senior Note Indenture contains certain covenants that, among other things, limit the Company's ability to incur additional indebtedness, engage in sale-leaseback transactions, pay dividends or make certain other distributions, sell assets, redeem capital stock, effect a consolidation or merger of KMC Telecom Holdings, Inc. and enter into transactions with stockholders and affiliates and create liens on our assets.

7. INTEREST RATE SWAP AGREEMENT

The Company has entered into an interest rate swap agreement with a commercial bank to reduce the impact of changes in interest rates on a portion of its outstanding variable rate debt. The agreement effectively fixes the Company's interest rate on \$125 million of the outstanding variable rate borrowings under the Senior Secured Credit Facility due 2007. The interest rate swap agreement terminates in April 2004. The Company is exposed to credit loss in the event of nonperformance by the other party to the interest rate swap agreement. However, the Company does not anticipate nonperformance by the counterparty.

8. REDEEMABLE AND NONREDEEMABLE EQUITY

KMC Telecom Preferred Stock

On January 21, 1997, certain convertible notes were converted into 123,800 shares of Series A Cumulative Convertible Preferred Stock of KMC Telecom with an aggregate liquidation value of \$12,380,000. Effective September 22, 1997, all of the shares of Series A Cumulative Convertible Preferred Stock of KMC Telecom were exchanged for an equal number of shares of Series A Cumulative Convertible Preferred Stock of KMC Holdings.

Pursuant to an agreement with Nassau, all dividends accumulated on the Series A Cumulative Convertible Preferred Stock of KMC Telecom through September 22, 1997 (\$592,000) were paid upon the closing of KMC Holdings' issuance of Senior Discount Notes and warrants on January 29, 1998.

Series E Preferred Stock

On February 4, 1999, the Company issued 25,000 shares of Series E Senior Redeemable, Exchangeable, PIK Preferred Stock (the "Series E Preferred Stock")

to Newcourt Finance, generating aggregate gross proceeds of \$22.9 million. On April 30, 1999, the Company issued an additional 35,000 shares of Series E Preferred Stock for gross proceeds of \$25.9 million. The Series E Preferred Stock has a liquidation preference of \$1,000 per share and an annual dividend equal to 14.5% of the liquidation preference, payable quarterly. On or before January 15, 2004, the Company may pay dividends in cash or in additional fully paid and nonassessable shares of Series E Preferred Stock. After January 15, 2004, dividends must be paid in cash, subject to certain conditions. Unpaid dividends accrue at the dividend rate of the Series E Preferred Stock, compounded quarterly. During 1999, the Company issued 5,004 shares of Series E Preferred Stock to pay the dividends due.

The Series E Preferred Stock must be redeemed on February 1, 2011, subject to the legal availability of funds therefor, at a redemption price, payable in

52

cash, equal to the liquidation preference thereof on the redemption date, plus all accumulated and unpaid dividends to the date of redemption. After April 15, 2004, the Series E Preferred Stock may be redeemed, in whole or in part, at the option of the Company, at a redemption price equal to 110% of the liquidation preference of the Series E Preferred Stock plus all accrued and unpaid dividends to the date of redemption. The redemption price declines to an amount equal to 100% of the liquidation preference as of April 15, 2007.

In addition, on or prior to April 15, 2002, the Company may, at its option, redeem up to 35% of the aggregate liquidation preference of Series E Preferred Stock with the proceeds of sales of its capital stock at a redemption price equal to 110% of the liquidation preference on the redemption date plus accrued and unpaid dividends.

The holders of Series E Preferred Stock have voting rights in certain circumstances. Upon the occurrence of a change of control, the Company will be required to make an offer to repurchase the Series E Preferred Stock for cash at a purchase price of 101% of the liquidation preference thereof, together with all accumulated and unpaid dividends to the date of purchase.

The Series E Preferred Stock is not convertible. The Company may, at the sole option of the Board of Directors (out of funds legally available), exchange all, but not less than all, of the Series E Preferred Stock then outstanding, including any shares of Series E Preferred Stock issued as payment for dividends, for a new series of subordinated debentures (the "Exchange Debentures") issued pursuant to an exchange debenture indenture. The holders of Series E Preferred Stock are entitled to receive on the date of any such exchange, Exchange Debentures having an aggregate principal amount equal to (i) the total of the liquidation preference for each share of Series E Preferred Stock exchanged, plus (ii) an amount equal to all accrued but unpaid dividends payable on such share.

Series F Preferred Stock

On February 4, 1999, the Company issued 40,000 shares of Series F Senior Redeemable, Exchangeable, PIK Preferred Stock (the "Series F Preferred Stock") to Lucent and Newcourt Finance, generating aggregate gross proceeds of \$38.9 million. The Series F Preferred Stock has a liquidation preference of \$1,000 per share and an annual dividend equal to 14.5% of the liquidation preference, payable quarterly. The Company may pay dividends in cash or in additional fully paid and nonassessable shares of Series F Preferred Stock. During 1999, the Company issued 4,177 shares of Series F Preferred Stock to pay the dividends due for such period.

The Series F Preferred Stock may be redeemed at any time, in whole or in part, at the option of the Company, at a redemption price equal to 110% of the liquidation preference on the redemption date plus an amount in cash equal to all accrued and unpaid dividends thereon to the redemption date. Upon the occurrence of a change of control, the Company will be required to make an offer to purchase the Series F Preferred Stock for cash at a purchase price of 101% of the liquidation preference thereof, together with all accumulated and unpaid dividends to the date of purchase.

The holders of Series F Preferred Stock have voting rights under certain circumstances.

Upon the earlier of (i) the date that is sixty days after the date on which the Company closes an underwritten primary offering of at least \$200 million of its Common Stock, pursuant to an effective registration statement under the Securities Act or (ii) February 4, 2001, any outstanding Series F Preferred Stock will automatically convert into Series E Preferred Stock, on a one for one basis.

The Company may, at the sole option of the Board of Directors (out of funds legally available), exchange all, but not less than all, of the Series F Preferred Stock then outstanding, including any shares of Series F Preferred Stock issued as payment for dividends, for Exchange Debentures. The holders of Series F Preferred Stock are entitled to receive on the date of any such exchange, Exchange Debentures having an aggregate principal amount equal to (i) the total of the liquidation preference for each share of Series F Preferred Stock exchanged, plus (ii) an amount equal to all accrued but unpaid dividends payable on such share.

Series A Preferred Stock

There are 123,800 shares of Series A Cumulative Convertible Preferred Stock of KMC Holdings ("Series A Preferred Stock") authorized and outstanding. Such stock was issued to two entities, Nassau Capital Partners, L.P. and NAS Partners I L.L.C. ("Nassau Capital" and "Nassau Partners", respectively, collectively

53

referred to as "Nassau") in January 1997 upon the conversion of certain notes payable and related accrued interest due to Nassau aggregating \$12,380,000. Series A Preferred Stock has a liquidation preference of \$100 per share and an annual dividend equal to 7.0% of the liquidation preference, payable quarterly, when and if declared by the Board of Directors out of funds legally available therefor. Unpaid dividends accumulate and the unpaid amount increases at the annual rate of 7.0%, compounded quarterly. All accumulated but unpaid dividends will be paid upon the occurrence of a Realization Event (defined as (i) an initial public offering with gross proceeds of at least \$40 million or (ii) sale of substantially all the assets or stock of the Company or the merger or consolidation of the Company into one or more other corporations). As of December 31, 1999, dividends in arrears on the Series A Preferred Stock aggregated \$2,116,000. Notwithstanding the foregoing, pursuant to an agreement among Nassau and the Company, Nassau has agreed to forego the payment of dividends from September 22, 1997 through the date on which Nassau disposes of its interest in the Company; provided that at the time of such disposition, Nassau has received not less than a 10% annual compound rate of return during the period it held the Series A Preferred Stock.

Series A Preferred Stock is convertible into Common Stock at a conversion price equal to \$20.63 per share of Common Stock, subject to adjustment upon the occurrence of certain events. Holders of Series A Preferred Stock may convert all or part of such shares to Common Stock. Upon conversion, subject to the aforementioned agreement to forego the payment of dividends, the holders are entitled to receive a cash payment of the accumulated but unpaid dividends; provided, however, that the Company may substitute common shares having a fair market value equal to the amount of such cash payment if the conversion occurs before a Realization Event. Series A Preferred Stock will automatically convert into Common Stock upon the occurrence of a Qualified Public Offering (defined as the first sale of Common Stock pursuant to a registration statement filed under the Securities Act of 1933 in which the Company receives gross proceeds of at least \$40 million, provided that the per share price at which such shares are sold in such offering is at least four times the conversion price of the Series A Preferred Stock).

The holders of Series A Preferred Stock, except as otherwise provided in the Company's Certificate of Incorporation, are entitled to vote on all matters voted on by holders of Common Stock. Each share of Series A Preferred Stock is entitled to a number of votes equal to the number of shares of Common Stock into

which such share is convertible. Without the prior consent of two-thirds of the shares of Series A Preferred Stock, among other things, the Company may not increase the number of shares of preferred stock (of whatever series) authorized for issuance, or declare or pay any dividends on shares of Common Stock or other junior shares. As discussed under "Redemption Rights" below, the holders of Series A Preferred Stock have certain redemption rights. Accordingly, such stock has been reflected as redeemable equity in the accompanying financial statements.

Series C Preferred Stock

There are 350,000 shares of Series C Cumulative Convertible Preferred Stock of KMC Holdings ("Series C Preferred Stock") authorized, of which 175,000 shares are outstanding at December 31, 1999. 150,000 of such shares were issued in November 1997, generating aggregate gross proceeds of \$15 million and the remaining 25,000 shares were issued in January 1998 upon the conversion of an equal number of shares of Series D Preferred Stock. Series C Preferred Stock has a liquidation preference of \$100 per share and an annual dividend equal to 7.0% of the liquidation preference, payable quarterly, when and if declared by the Board of Directors out of funds legally available therefor. Unpaid dividends accumulate and the unpaid amount increases at the annual rate of 7.0%, compounded quarterly. All accumulated but unpaid dividends will be paid upon the occurrence of a Realization Event. As of December 31, 1999, dividends in arrears on the Series C Preferred Stock aggregated \$2,821,000. Notwithstanding the foregoing, pursuant to the Purchase Agreement among the Company, Nassau, GECC and First Union Corp. ("First Union"), each current holder of Series C Preferred Stock has agreed to forego the payment of dividends that accumulate during the period from issuance through the date on which such holder disposes of its interest in the Company; provided that at the time of such disposition, it has received not less than a 10% annual compound rate of return during such period.

Series C Preferred Stock is convertible into Common Stock at a conversion price equal to (i) from the date of initial issuance to the date which is 30 months after the date of such initial issuance, \$52.50 per share of Common Stock and (ii) from and after the date which is 30 months after the date of initial issuance, \$42.18; provided that both such amounts are subject to adjustment upon the occurrence of certain events. Holders of Series C Preferred Stock may convert all or part of such shares to Common Stock. Upon conversion, subject to the aforementioned agreement to forego the payment of dividends, the holders are entitled to receive a cash payment of the accumulated but unpaid dividends; provided, however, that the Company may substitute common shares having a fair

54

market value equal to the amount of such cash payment if the conversion occurs before a Realization Event. Series C Preferred Stock will automatically convert into Common Stock upon the occurrence of a Qualified Public Offering.

The holders of Series C Preferred Stock, except as otherwise provided in the Company's Certificate of Incorporation, are entitled to vote on all matters voted on by holders of Common Stock. Each share of Series C Preferred Stock is entitled to a number of votes equal to the number of shares of Common Stock into which such share is convertible. Without the prior consent of two-thirds of the shares of Series C Preferred Stock, among other things, the Company may not increase the number of shares of preferred stock (of whatever series) authorized for issuance, or declare or pay any dividends on shares of Common Stock or other junior shares. As discussed under "Redemption Rights" below, the holders of Series C Preferred Stock have certain redemption rights. Accordingly, such stock has been reflected as redeemable equity in the accompanying financial statements.

The Series C Preferred Stock is subject to redemption at the option of the Company, in whole but not in part, in connection with an "Acquisition Event." An Acquisition Event is defined to mean any merger or consolidation of the Company with any other company, person or entity, whether or not the Company is the surviving entity, as a result of which the holders of the Company's Common Stock (determined on a fully diluted basis) will hold less than a majority of the outstanding shares of Common Stock or other equity interest of the Company, person or entity resulting from such transaction, or any parent of such entity.

Series D Preferred Stock

There are 25,000 shares of Series D Cumulative Convertible Preferred Stock of KMC Holdings ("Series D Preferred Stock") authorized, none of which are outstanding at December 31, 1999. There were 25,000 of such shares issued to Nassau in November 1997, generating aggregate gross proceeds of \$2.5 million. In January 1998, Nassau exercised its conversion rights and converted all of its shares of Series D Preferred Stock into an equal number of shares of Series C Preferred Stock.

Common Stock

Holders of Common Stock of the Company are entitled to one vote for each share held on all matters submitted to a vote of stockholders, except with respect to the election of Directors. Except as otherwise required by law, actions at the Company's stockholders meetings (held at least annually), require the affirmative vote of a majority of the shares represented at the meeting, a quorum being present. Holders of Common Stock are entitled, subject to the preferences of preferred stock, to receive such dividends, if any, as may be declared by the Board of Directors out of funds legally available therefor. The Senior Discount Note Indenture and the Company's other indebtedness restrict the ability of the Company to pay dividends on its Common Stock. Without the prior consent of two-thirds of the shares of Series A Preferred Stock and two-thirds of the shares of Series C Preferred Stock, the Company may not declare or pay any dividends on its Common Stock. Except as discussed under "Redemption Rights" below, the holders of Common Stock have no preemptive, redemption or conversion rights.

Pursuant to provisions contained in the Company's Certificate of Incorporation and an Amended and Restated Stockholders Agreement dated as of October 31, 1997, among the Company, Kamine, Nassau, Newcourt Communications Finance Corp., GECC, and First Union (the "Stockholders' Agreement"), until Kamine and Nassau cease to own Common Stock or preferred stock convertible into Common Stock representing at least five percent of the outstanding shares of Common Stock, assuming all convertible securities are converted, Kamine and Nassau have special rights entitling each to elect three Directors. A Director elected by Kamine's shares or Nassau's shares may not be removed except with the affirmative vote of a majority of the applicable shares of capital stock. If Kamine or Nassau transfer their shares of capital stock, the number of Directors their shares are entitled to elect decreases. The number of Directors which Kamine is entitled to elect would be reduced to two if the number of shares owned by him were to fall below two-thirds of the number of shares of the Company initially issued to him, and to one if the number of shares owned by him were to fall below one-third of the number of shares initially issued to him. If his ownership were to fall below 5% of the number of shares initially issued to him, Kamine would no longer be entitled to elect any Directors pursuant to such provisions. Comparable reductions would be made to the number of Directors which Nassau is entitled to elect if its ownership were to fall below the specified percentages. Directors other than those elected by vote of Kamine's shares or Nassau's shares are elected by holders of Common Stock and holders of preferred stock that are entitled to vote in the election of Directors. If a default relating to payment occurs under the Senior Secured Credit Facility and

55

continues uncured for 90 days, the holders of Series C Preferred Stock (currently Nassau, GECC and First Union) are entitled to elect two additional Directors, who will serve until the default is cured.

Redemption Rights

Pursuant to a stockholders agreement, certain of the Company's stockholders and warrant holders have "put rights" entitling them to have the Company repurchase their preferred and common shares and redeemable common stock warrants for the fair value of such securities if no Liquidity Event (defined as (i) an initial public offering with gross proceeds of at least \$40 million, (ii) the sale of substantially all of the stock or assets of the Company or (iii) the merger or consolidation of the Company with one or more other corporations) has taken

place by the later of (x) October 22, 2003 or (y) 90 days after the final maturity date of the Senior Discount Notes. The restrictive covenants of the Senior Discount Notes limit the Company's ability to repurchase such securities. All of the securities subject to such "put rights" are presented as redeemable equity in the accompanying balance sheets.

The redeemable preferred stock, redeemable common stock and redeemable common stock warrants, which are subject to the stockholders agreement, are being accreted up to their fair market values from their respective issuance dates to their earliest potential redemption date (October 22, 2003). At December 31, 1999, the aggregate redemption value of the redeemable equity was approximately \$320 million, reflecting per share redemption amounts of \$1,212 for the Series A Preferred Stock, \$476 for the Series C Preferred Stock and \$250 for the redeemable common stock and redeemable common stock warrants.

Warrants

In connection with KMC Telecom's 1996 Loan and Security Agreement, warrants representing a 2.5% ownership interest in the fully diluted common voting capital stock of KMC Telecom, including anti-dilution protection, were granted to the lenders. These warrants, at an exercise price of \$.01 per share, were issued on January 21, 1997, concurrent with the initial borrowing under the AT&T Facility, at which date the fair value of such warrants was determined to be \$1.5 million, which was reflected as a charge to deferred financing costs and credited to redeemable equity in January 1997. On September 22, 1997, such warrants were exercised, and an aggregate of 28,000 shares of Class A Common Stock of KMC Telecom were issued to the warrant holders. These shares were subsequently exchanged for an equal number of shares of Common Stock of KMC Holdings.

In connection with the AT&T Facility, warrants to purchase 10,000 shares of Common Stock were issued to GECC in 1997. These warrants, at an exercise price of \$.01 per share, are exercisable from issuance through January 21, 2005. The fair value of such warrants was determined to be \$525,000, which was reflected as a charge to deferred financing costs and credited to redeemable equity. Pursuant to the Stockholders' Agreement, GECC may put the shares of Common Stock issuable upon the exercise of such warrants back to the Company. These warrants have been presented as redeemable common stock warrants in the accompanying balance sheet at December 31, 1999.

In connection with the sale of Senior Discount Notes in January 1998, the Company issued warrants to purchase an aggregate of 100,385 shares of Common Stock at an exercise price of \$.01 per share. The net proceeds of \$10,446,000 represented the fair value of the warrants at the date of issuance. The warrants are exercisable through January 2008.

In connection with the February 4, 1999 issuances of the Series E Preferred Stock and the Series F Preferred Stock, warrants to purchase an aggregate of 24,660 shares of Common Stock were sold to Newcourt Finance and Lucent. The aggregate gross proceeds from the sale of these warrants was approximately \$3.2 million. These warrants, at an exercise price of \$.01 per share, are exercisable from February 4, 2000 through February 1, 2009.

In addition, the Company also delivered to the Warrant Agent certificates representing warrants to purchase an aggregate of an additional 107,228 shares of Common Stock at an exercise price of \$.01 per share (the "Springing Warrants"). The Springing Warrants may become issuable under the circumstances described in the following paragraph.

If the Company fails to redeem all shares of Series F Preferred Stock prior to the date (the "Springing Warrant Date") which is the earlier of (i) the date that is sixty days after the date on which the Company closes an underwritten primary offering of at least \$200 million of its Common Stock pursuant to an

effective registration statement under the Securities Act or (ii) February 4, 2001, the Warrant Agent is authorized to issue the Springing Warrants to the Eligible Holders (as defined in the warrant agreement) of the Series E and

Series F Preferred Stock. In the event the Company has redeemed all outstanding shares of Series F Preferred Stock prior to the Springing Warrant Date, the Springing Warrants will not be issued and the Warrant Agent will return the certificates to the Company. To the extent the Company exercises its option to exchange all of the Series F Preferred Stock for Exchange Debentures prior to the Springing Warrant Date, the Springing Warrants will not become issuable. Therefore, as the future issuance of the Springing Warrants is entirely within the control of the Company and the likelihood of their issuance is deemed to be remote, no value has been ascribed to the Springing Warrants.

In connection with the April 30, 1999 issuance of additional shares of the Series E Preferred Stock, warrants to purchase an aggregate of 60,353 shares of Common Stock were issued to Newcourt Finance and First Union. The aggregate gross proceeds from the sale of these warrants was approximately \$9.1 million. These warrants, at an exercise price of \$.01 per share, are exercisable from February 4, 2000 through February 1, 2009.

Options

Prior to the establishment of the present holding company structure, during 1996 and 1997, KMC Telecom granted options to purchase shares of its common stock, par value \$.01 per share ("KMC Telecom Common Stock"), to employees pursuant to the KMC Telecom Stock Option Plan.

In order to reflect the establishment of the holding company structure, on June 26, 1998, the Board of Directors adopted a new stock option plan, the KMC Holdings Stock Option Plan (the "1998 Plan"), which authorizes the grant of options to purchase Common Stock of the Company. The 1998 Plan was approved by the stockholders, effective July 15, 1998. In September 1998, the Company replaced the options to purchase KMC Telecom Common Stock previously granted under the KMC Telecom Stock Option Plan with options to purchase Common Stock of the Company granted under the 1998 Plan and granted options to additional employees of the Company under the 1998 Plan.

The 1998 Plan, which is administered by the Compensation Committee of the Board of Directors of KMC Holdings, provides for various grants to key employees, directors, affiliated members or other persons having a unique relationship with the Company excluding Kamine and any person employed by Nassau Capital or any Nassau affiliate. Grants may include, without limitation, incentive stock options, non-qualified stock options, stock appreciation rights, dividend equivalent rights, restricted stocks, purchase stocks, performance shares and performance units. The Compensation Committee has the power and authority to designate recipients of the options and to determine the terms, conditions, and limitations of the options.

Under the 1998 Plan, options to purchase 600,000 shares of Common Stock of KMC Holdings are available for grant, all of which were allocated to the Plan as of December 31, 1999. No individual may receive options for more than 75,000 shares. The exercise price of all incentive stock options granted under the 1998 Plan must be at least equal to the fair market value of the shares on the date of grant. The exercise price of all non-qualified stock options granted under the 1998 Plan must be at least 50% of the fair market value of the shares on the date of grant.

Options granted pursuant to the 1998 Plan will have terms not to exceed 10 years and become exercisable over a vesting period as specified in such options. The 1998 Plan will terminate no later than 2008. Options granted under the 1998 Plan are nontransferable, other than by will or by the laws of descent and distribution, and may be exercised during the optionee's lifetime, only by the optionee.

The 1998 Plan provides for an adjustment of the number of shares exercisable in the event of a merger, consolidation, recapitalization, change of control, stock split, stock dividend, combination of shares or other similar changes, exchange or reclassification of the Common Stock at the discretion of the Compensation Committee. Pursuant to the agreements adopted under the 1998 Plan, the greater of 25% of the shares granted or fifty percent of all unvested options granted become fully vested upon a change-in-control of the Company, as defined. Under certain circumstances, such percentages may increase.

The holders of options to acquire shares of Common Stock of KMC Holdings are

required to enter into agreements with KMC Holdings which place certain restrictions upon their ability to sell or otherwise transfer such shares. In the event of termination of employment of the option holder by the Company or

57

the affiliates, the Company can repurchase all of the shares or options held by such individuals, generally for an amount equal to the fair value of such shares or the excess of the fair value of such options over their exercise price.

Information on stock options is as follows:

	NUMBER OF SHARES		WEIGHTED
	OUTSTANDING	EXERCISABLE	AVERAGE EXERCISE PRICE OF OPTIONS
Balances, January 1, 1997.....	95,385	-	\$ 65
Granted.....	63,115	-	\$ 65
Became exercisable.....	-	22,000	
Cancelled.....	(17,000)	(3,000)	\$ (65)
Balances, December 31, 1997.....	141,500	19,000	\$ 65
Granted.....	262,500	-	\$ 26
Became exercisable.....	-	117,000	
Cancelled.....	(141,500)	(19,000)	\$ (65)
Balances, December 31, 1998.....	262,500	117,000	\$ 26
Granted.....	82,342	-	\$147
Became exercisable.....	-	51,669	
Exercised.....	(15,600)	(15,600)	\$ 22
Cancelled.....	(27,200)	(2,000)	\$ (26)
Balances, December 31, 1999.....	302,042	151,069	\$ 59

The weighted-average exercise price of options exercisable at December 31, 1997, 1998 and 1999 is \$50, \$22 and \$26, respectively, and the weighted-average fair value of options granted during 1997, 1998 and 1999 were \$49, \$114 and \$134 per share, respectively.

The range of exercise prices, number of shares and the weighted-average remaining contractual life for options outstanding as of December 31, 1999 were as follows:

WEIGHTED- AVERAGE REMAINING CONTRACTUAL LIFE	RANGE OF EXERCISE PRICES	NUMBER OF SHARES	NUMBER OF SHARES EXERCISABLE	WEIGHTED- AVERAGE EXERCISE PRICE
8.66 years	\$20 - \$40	219,700	144,025	\$ 21
9.0 years	\$125	67,509	6,751	125
9.70 years	\$225 - \$250	14,833	293	225
8.79 years	Total \$20 - \$250	302,042	151,069	26

During the year ended December 31, 1999, non-qualified options to purchase an aggregate of 82,342 shares were granted to employees at exercise prices of \$125 (67,509), \$225 (2,933) and \$250 (11,900). All options have 10 year terms and become exercisable over a five year period in equal six month increments.

During the year ended December 31, 1998, non-qualified options to purchase an aggregate of 262,500 shares were granted at exercise prices of \$20 (157,500 options), \$30 (52,500 options) and \$40 (52,500 options). The options granted during 1998 are comprised of 230,500 options granted to employees and 32,000 options granted to individuals employed by certain affiliates of the Company. All such options have 10 year terms. The \$20 options become exercisable over a three year period in six month intervals commencing six months after the grant date in increments of 26,250 options each. The \$30 options become exercisable in two increments of 26,250 options each, forty-two and forty-eight months after the grant date. The \$40 options become exercisable in two increments of 26,250 options each, fifty-four and sixty months after the grant date. For purposes of vesting, options granted in 1998 under the 1998 Plan to replace options granted in 1997 and 1996 under the KMC Telecom Stock Option Plan are deemed to have been granted on the date of grant of the options which they replace.

58

As a result of certain anti-dilution provisions governing the conversion of shares of Class C Common Stock into shares of Class A Common Stock, KMC Telecom was required to account for the KMC Telecom Stock Option Plan as a variable stock option plan. Additionally, as a result of restrictions upon the holders of options granted under the 1998 Plan, including their ability to sell or otherwise transfer the related shares, the 1998 Plan is required to be accounted for as a variable stock option plan. Generally accepted accounting principles for variable stock option plans require the recognition of a non-cash compensation charge for these options (amortized over the vesting period of the employee options and recognized in full as of the grant date for the non-employee options). Such charge is determined by the difference between the fair value of the common stock underlying the options and the option price as of the end of each period. Accordingly, compensation expense will be charged or credited periodically through the date of exercise or cancellation of such stock options, based on changes in the value of the Company's stock as well as the vesting schedule of such options. These compensation charges or credits are non-cash in nature, but could have a material effect on the Company's future reported results of operations.

The Company, upon cancellation of the outstanding options under the KMC Telecom Stock Option Plan, reversed all compensation expense previously recorded with respect to such options. Additionally, to the extent the fair value of the Common Stock of the Company exceeded the exercise price of the options granted under the 1998 Plan, the Company recognized compensation expense related to such options over their vesting period.

Based on the estimated fair value of the Common Stock of KMC Telecom at December 31, 1997 and KMC Holdings at December 31, 1998 and December 31, 1999, cumulative deferred compensation obligations of \$15,579,000, \$27,906,000 and \$50,972,000, respectively, have been established. The Company has recognized compensation expense aggregating \$13,870,000, \$7,080,000 and \$29,833,000, for the years ended December 31, 1997, 1998 and 1999, respectively. The 1998 stock option compensation expense of \$7,080,000 reflects charges of \$7,236,000 under the KMC Telecom Stock Option Plan through its termination in September 1998 and charges of \$21,190,000 related to the 1998 Plan, partially offset by a credit as a result of the September 1998 cancellation of the KMC Telecom stock options, reflecting the reversal of \$21,346,000 of cumulative compensation previously recognized for options granted under the KMC Telecom Stock Option Plan.

In accordance with the provisions of Statement 123, the Company applies APB 25 and related interpretations in accounting for its stock option plan. If the Company had elected to recognize compensation expense based on the fair value of the options granted at the grant date as prescribed by Statement 123, net loss and net loss per common share would have been the following:

	1997	DECEMBER 31 1998	1999
	(in thousands, except per share amounts)		
Net loss:			
As reported.....	\$ (32,685)	\$ (76,753)	\$ (225,716)
Pro forma.....	\$ (20,542)	\$ (76,869)	\$ (219,599)
Net loss per common share:			
As reported.....	\$ (64.93)	\$ (114.42)	\$ (360.88)
Pro forma.....	\$ (45.97)	\$ (114.56)	\$ (353.70)

The fair value of each option grant is estimated on the date of grant using the Black-Scholes option-pricing model with the following weighted average assumptions:

	1997	1998	1999
Expected dividend yield.....	0%	0%	0%
Expected stock price volatility.....	50%	50%	70%
Risk-free interest rate.....	6%	6%	
6.5%			
Expected life of options.....	7 years	7 years	7
years			

59

The expected stock price volatility factors were determined based on an average of such factors as disclosed in the financial statements of peer companies. The Black-Scholes option valuation model was developed for use in estimating the fair value of traded options which have no vesting restrictions and are fully transferable. In addition, option valuation models require the input of highly subjective assumptions including the expected stock price volatility. Because the Company's employee stock options have characteristics significantly different from those of traded options, and because changes in the subjective input assumptions can materially affect the fair value estimate, in management's opinion, the existing models do not necessarily provide a reliable single measure of the fair value of its employee stock options.

9. SERVICE REVENUES

The Company provides on-net switched and dedicated services and resells switched services previously purchased from the incumbent local exchange carrier. On-net services include both services provided through direct connections to our own networks and services provided by means of unbundled network elements leased from the incumbent local exchange carrier.

The Company's service revenues consist of the following:

	1997	YEAR ENDED DECEMBER 31 1998	1999
	(in thousands)		
On-net.....	\$1,093	\$ 8,248	\$44,615
Resale.....	2,324	14,177	19,698
Total.....	\$3,417	\$22,425	\$64,313

10. INCOME TAXES

As of December 31, 1999, the Company and its subsidiaries had consolidated net operating loss carryforwards for United States income tax purposes ("NOLs") of approximately \$215 million which expire through 2013. Under Section 382 of the Internal Revenue Code of 1986, as amended, if the Company undergoes an "ownership change," its ability to use its preownership change NOLs (NOLs accrued through the date of the ownership change) would generally be limited annually to an amount equal to the product of (i) the long-term tax-exempt rate for ownership changes prescribed monthly by the Treasury Department and (ii) the value of the Company's equity immediately before the ownership change, excluding certain capital contributions. Any allowable portion of the preownership change NOLs that is not used in a particular taxable year following the ownership change could be carried forward to subsequent taxable years until the NOLs expire, usually 15 years after they are generated. As a result of the cumulative effect of issuances of preferred and common stock through September 22, 1997, KMC Telecom has undergone an ownership change.

For financial reporting purposes, the Company has an aggregate of approximately \$109 million and \$311 million of loss carryforwards and net temporary differences at December 31, 1998 and 1999, respectively. At existing federal and state tax rates, the future benefit of these items approximates \$42 million at December 31, 1998 and \$121 million at December 31, 1999. Valuation allowances have been established equal to the entire net tax benefit associated with all carryforwards and temporary differences at both December 31, 1998 and 1999 as their realization is uncertain.

60

The composition of expected future tax benefits at December 31, 1998 and 1999 is as follows:

	1998	1999
	(in thousands)	
Net operating loss carryforwards.....	\$ 22,914	\$ 83,762
Temporary differences:		
Stock option compensation.....	8,264	19,528
Interest accretion.....	9,797	21,127
Other, net.....	1,513	(3,244)
Total deferred tax assets.....	42,488	121,173
Less valuation allowance.....	(42,488)	(121,173)
Net deferred tax assets.....	\$ -	\$ -

A reconciliation of the expected tax benefit at the statutory federal rate of 35% is as follows:

	1997	1998
1999		
Expected tax benefit at statutory rate.....	(35.0)%	(35.0)%
(35.0)%		
State income taxes, net of federal benefit.....	(2.9)	(2.6)
(3.8)		
Non-deductible interest expense.....	-	2.0
1.1		

Other.....	.1	.1
.1		
Change in valuation allowance.....	37.8	35.5
37.6		
	-----	-----
	-8	-8
-8		
=====		

11. COMMITMENTS AND CONTINGENCIES

Leases

The Company leases various facilities and equipment under operating leases. Minimum rental commitments are as follows (in thousands):

Year ending December 31:	
2000.....	\$ 4,434
2001.....	5,317
2002.....	4,754
2003.....	4,145
2004.....	3,302
Thereafter.....	13,219

	\$35,171
	=====

Rent expense under operating leases was \$478,000, \$1,299,000 and \$3,815,000, for the years ended December 31, 1997, 1998 and 1999, respectively.

Litigation

There are a number of lawsuits and regulatory proceedings related to the Telecommunications Act of 1996, decisions of the Federal Communications Commission related thereto and rules and regulations issued thereunder which may affect the rights, obligations and business of incumbent local exchange carriers, competitive local exchange carriers and other participants in the telecommunications industry in general, including the Company.

61

Purchase Commitments

As of December 31, 1999, the Company has outstanding commitments aggregating approximately \$96.5 million related to purchases of telecommunications equipment and fiber optic cable and its obligations under its agreements with certain suppliers and service providers.

Employment Agreements

The Company has entered into employment agreements with certain of its executives. In addition to a base salary, these agreements also provide for certain incentive compensation payments, based upon completion of construction and attainment of specified revenues for additional networks. The Company has also agreed to make similar incentive compensation payments to certain other key employees.

Arbitration Award

During the second quarter of 1999, the Company recorded a \$4.3 million charge to other expense in connection with an unfavorable arbitration award. The net amount due under the terms of the award was paid in full in June 1999.

12. ACQUISITION

On July 11, 1997, KMC Telecom acquired a network in Melbourne, Florida for a purchase price of \$2 million in cash. The acquisition was accounted for under the purchase method and the purchase price approximated the fair value of the fixed assets acquired. Assuming the Melbourne Network had been acquired as of January 1, 1997, the Company's pro forma consolidated revenue and net loss for the year ended December 31, 1997 would have been \$3,655,000 and \$33,212,000, respectively.

13. RELATED PARTY TRANSACTIONS

The Company and certain affiliated companies owned by Kamine share certain administrative services. The entity which bears the cost of the service is reimbursed by the other for the other's proportionate share of such expenses. The Company reimbursed Kamine-affiliated companies for these shared services an aggregate of approximately \$281,000, \$136,000 and \$60,000, of expense for the years ended December 31, 1997, 1998 and 1999, respectively. During 1999, the Company purchased approximately \$180,000 of office furniture and leasehold improvements from an entity controlled by Kamine.

From May 1, 1996 through January 29, 1998, an affiliate of the Company was paid a fee at an annual rate of \$266,000 as reimbursement for the services of Kamine as Chairman of the Board of the Company. The amount of this fee was reduced to \$100,000 per annum as of January 29, 1998 and it was terminated effective December 31, 1998. The fees paid for these services are included in the shared services payment described in the immediately preceding paragraph.

The Company leases its headquarters office through January 2007 from an entity controlled by Kamine. The lease provides for a base annual rental cost of approximately \$217,000, adjusted periodically for changes in the consumer price index, plus operating expenses. Rent expense recognized under this lease for the years ended December 31, 1997, 1998 and 1999 was \$207,000, \$217,000 and \$217,000, respectively.

Effective January 1, 1999, the Company is entitled to utilize a Citation III business jet, chartered by Bedminster Aviation, LLC, a limited liability company wholly-owned by Kamine, for a fixed price per hour of flight time. During 1999, the Company paid approximately \$210,000 for the use of the Citation III. The Company has agreed to use its best efforts to utilize the Citation III fifty hours per quarter during 2000. The Company is under no obligation to do so and has not guaranteed any financial arrangements with respect to the aircraft or to Bedminster Aviation, LLC.

Pursuant to an agreement among the Company, Kamine and Nassau, for 1997, 1998 and 1999 Nassau received \$100,000, \$100,000 and \$450,000, respectively, as a financial advisory fee and as compensation for the Nassau designees who served on the Board of Directors of the Company. Nassau will be paid \$450,000 as a financial advisory fee for 2000.

62

As of December 31, 1998 and 1999, the Company has made loans aggregating \$760,000 and \$575,000, respectively, to certain of its executives. Such loans bear interest at a rate of 6% per annum and are included in other assets.

14. NET LOSS PER COMMON SHARE

The following table sets forth the computation of net loss per common share:

	1997	1998	1999
	(in thousands, except per share amounts)		
Numerator:			
Net loss.....	\$ (32,686)	\$ (76,753)	\$ (225,716)
Dividends and accretion on redeemable preferred stock.....	(8,904)	(18,285)	(81,633)
Numerator for net loss per common share....	\$ (41,590)	\$ (95,038)	\$ (307,349)

Denominator:			
Denominator for net loss per common share - weighted average number of common shares outstanding.....	641	831	852
Net loss per common share.....	\$ (64.93)	\$ (114.42)	\$ (360.68)

Options and warrants to purchase an aggregate of 242,768, 372,885 and 496,729 shares of common stock were outstanding as of December 31, 1997, 1998 and 1999, respectively, but a computation of diluted net loss per common share has not been presented, as the effect of such securities would be anti-dilutive.

15. SUPPLEMENTAL DISCLOSURE OF NONCASH INVESTING AND FINANCING ACTIVITIES

Information with respect to noncash investing and financing activities is as follows:

In connection with the Senior Discounts Notes, the Company recognized noncash interest expense of \$29.6 and \$36.4 million in 1998 and 1999, respectively.

During 1999, the Company issued stock dividends to the holders of the Series E Preferred Stock and Series F Preferred Stock of 5,004 shares and 4,177 shares, respectively.

In 1997, certain convertible notes, including accrued interest, aggregating approximately \$12,380,000 were converted into 123,800 shares of Series A Cumulative Convertible Preferred Stock of KMC Telecom.

In 1997, warrants with a fair value of \$1.5 million were granted to Newcourt and warrants with a fair value of \$525,000 were granted to GECC.

In connection with options granted to employees under the KMC Holdings Stock Option Plan in 1998 and 1999, and under the KMC Telecom Stock Option Plan in 1997, cumulative deferred compensation obligations of \$15,579,000, \$27,906,000 and \$50,972,000, have been established in 1997, 1998 and 1999, respectively, with offsetting credits to additional paid-in capital. Noncash compensation expense of \$9,014,000, \$23,758,000 and \$23,947,000 in 1997, 1998 and 1999, respectively, was recognized in connection with such options. In connection with options granted to individuals employed by certain affiliates of the Company in 1997, 1998 and 1999, the Company recognized noncash compensation expense of \$4,856,000, \$4,668,000 and \$5,886,000, respectively. In addition, during 1998 the Company cancelled all of the then outstanding options granted under the KMC Telecom Stock Option Plan, resulting in the reversal of previously recognized compensation expense of \$21.3 million.

63

16. FINANCIAL INSTRUMENTS

The following methods and assumptions were used to estimate the fair value of each class of financial instruments.

Cash and Cash Equivalents

The carrying amounts approximate fair value because of the short-term maturity of the instruments.

Investments Held for Future Capital Expenditures

The carrying amounts and fair value are reported at amortized cost since these securities are to be held to maturity.

Long-Term Debt

The carrying amount of floating-rate long-term debt approximates its fair value. The fair value of the Company's fixed-rate long-term debt is estimated using discounted cash flows at the Company's incremental borrowing rates.

Redeemable Equity

The fair value of the Company's redeemable equity instruments are estimated to be the amounts at which the holders may require the Company to redeem such securities, adjusted using discounted cash flows.

Interest Rate Swap

At December 31, 1999, the Company had an interest rate swap agreement to reduce the impact on interest expense of fluctuations in interest rates on a portion of its variable rate debt. The effect of this agreement is to limit the Company's interest rate exposure on a notional amount of debt of \$125 million. The fair value was estimated as the amount the Company would receive if the swap agreement was terminated at December 31, 1999.

Estimated Fair Values

The carrying amounts and estimated fair values of the Company's financial instruments are as follows (in millions):

	1998		1999	
	CARRYING AMOUNT	FAIR VALUE	CARRYING AMOUNT	FAIR VALUE
Cash and cash equivalents.....	\$ 21.1	\$ 21.1	\$ 86.0	\$ 86.0
Investments held for future capital expenditures.....	27.9	27.9	-	-
Long-term debt:				
Floating rate.....	41.4	41.4	235.0	235.0
Fixed rate - Senior Discount Notes.....	267.8	249.6	301.1	275.7
Fixed rate - Senior Notes.....	-	-	275.0	263.5
Redeemable equity instruments:				
Series E Preferred Stock.....	-	-	50.8	57.7
Series F Preferred Stock.....	-	-	41.4	39.2
Series A Preferred Stock.....	30.4	38.9	71.3	86.5
Series C Preferred Stock.....	21.6	21.6	40.3	48.0
Redeemable common stock.....	22.3	14.5	33.8	34.4
Redeemable common stock warrants.....	.7	.7	12.9	13.7
Interest rate swap (asset).....	-	-	-	3.9

Concentrations of Credit Risk

Financial instruments that potentially subject the Company to significant concentrations of credit risk consist principally of cash investments and accounts receivable. The Company places its cash investments with major

64

financial institutions. With respect to accounts receivable, the Company performs ongoing credit evaluations of its customers' financial conditions and generally does not require collateral. No individual customer accounted for more than 10% of revenue, excluding reciprocal compensation revenue, as described below, for any of the years ended December 31, 1997, 1998 or 1999.

The Company maintains interconnection agreements with the major incumbent local exchange carriers ("ILECs") in each state in which it operates. Among other things, these contracts govern the reciprocal amounts to be billed by competitive carriers for terminating local traffic of Internet service providers ("ISPs") in each state. ILECs around the country have been contesting whether the obligation to pay reciprocal compensation to competitive local exchange carriers should apply to local telephone calls from an ILEC's customers to ISPs served by competitive local exchange carriers. The ILECs claim that this traffic is interstate in nature and therefore should be exempt from compensation arrangements applicable to local intrastate calls. Competitive local exchange carriers have contended that the interconnection agreements provide no exception for local calls to ISPs and reciprocal compensation is therefore applicable. The ILECs have threatened to withhold, and in many cases have withheld, reciprocal

compensation to competitive local exchange carriers for the transport and termination of these calls. During 1998 and 1999, the Company recognized revenue from these ILECs of approximately \$2.9 million and \$9.7 million, or 12.9% and 15.1% of 1998 and 1999 revenue, respectively, for these services. Payments of approximately \$135,000 and \$1.6 million were received from the ILECs during 1998 and 1999, respectively.

The Company determined to recognize this revenue because management concluded, based upon all of the facts and circumstances available to them at the time, including numerous state public service commission and state and federal court decisions upholding competitive local exchange carriers' entitlement to reciprocal compensation for such calls, that realization of those amounts was reasonably assured. On October 13, 1999, however, the Louisiana Public Service Commission ruled that local traffic to Internet service providers in Louisiana is not eligible for reciprocal compensation. As a result of that ruling, management determined that the Company could no longer conclude that realization of amounts attributable to reciprocal compensation for termination of local calls to Internet service providers in Louisiana was reasonably assured. Accordingly, the Company recorded an adjustment to reduce revenue in the quarter ended September 30, 1999, which reversed all reciprocal compensation revenue previously recognized related to Internet service provider traffic in Louisiana for the entire year of 1998 and for the first nine months of 1999. The adjustment amounted to \$4.4 million, of which \$1.1 million relates to the year ended December 31, 1998 and \$3.3 million relates to the nine months ended September 30, 1999.

South Carolina has also ruled that ILECs are not obligated to pay reciprocal compensation for termination of local calls to ISPs. As a result, unless that decision is reversed we will not recognize revenue for such calls in South Carolina.

Currently, over 30 state commissions and several federal and state courts have ruled that reciprocal compensation arrangements do apply to calls to ISPs, while four jurisdictions have ruled to the contrary. A number of these rulings are subject to appeal. Additional disputes over the appropriate treatment of ISP traffic are pending in other states. On February 26, 1999, the Federal Communications Commission issued a declaratory ruling determining that ISP traffic is interstate for jurisdictional purposes, but that its current rules neither require nor prohibit the payment of reciprocal compensation for such calls. In the absence of a federal rule, the Federal Communications Commission determined that state commissions have authority to interpret and enforce the reciprocal compensation provisions of existing interconnection agreements, and to determine the appropriate treatment of ISP traffic in arbitrating new agreements. The Federal Communications Commission also requested comment on alternative federal rules to govern compensation for such calls in the future. In response to the Federal Communications Commission ruling some ILECs have asked state commissions to reopen previous decisions requiring the payment of reciprocal compensation on ISP calls. Some ILECs and some competitive local exchange carriers appealed the Federal Communications Commission's declaratory ruling to the United States Court of Appeals for the District of Columbia Circuit, which issued a decision on March 24, 2000, vacating the declaratory ruling. The court stated that the Federal Communications Commission had not adequately explained its conclusion that calls to ISPs should not be treated as local traffic for reciprocal compensation purposes. Management views this decision as favorable, but the court's direction to the Federal Communications Commission to re-examine the issue will likely result in further delay in the resolution of pending compensation disputes, and there can be no assurance as to the ultimate outcome of these proceedings.

The Company accounts for reciprocal compensation with the ILECs, including the activity associated with the disputed ISP traffic, as local traffic pursuant to the terms of its interconnection agreements in all jurisdictions other than Louisiana and South Carolina. Accordingly, revenue is recognized in the period

that the traffic is terminated. The circumstances surrounding the disputes are considered by management periodically in determining whether reserves against unpaid balances are warranted. As of December 31, 1999, no reserves have been

considered necessary by management.

17. SUPPLEMENTAL GUARANTOR INFORMATION

In May 1999, KMC Holdings sold \$275,000,000 aggregate principal amount of Senior Notes. KMC Telecom Financing Inc. (the "Guarantor"), a wholly-owned subsidiary of the Company, has fully and unconditionally guaranteed the Company's obligations under these notes. Separate financial statements and other disclosures of the Guarantor are not presented because management determined the information is not material to investors. No restrictions exist on the ability of the Guarantor to make distributions to the Company except to the extent provided by law generally (adequate capital to pay dividends under corporate laws) and restrictions contained in the Company's credit facilities. The following condensed consolidating financial information presents the results of operations, financial position and cash flows of KMC Holdings (on a stand alone basis), the guarantor subsidiary (on a stand alone basis), the non-guarantor subsidiaries (on a combined basis) and the eliminations necessary to arrive at the consolidated results for the Company at December 31, 1999 and for the year then ended. The non-guarantor subsidiaries include KMC Telecom, KMC Telecom II, KMC Telecom III, KMC Telecom Virginia, Inc. and KMC Telecom Financial Services LLC (collectively, the "Non-Guarantor Subsidiaries").

66

GUARANTOR/NON-GUARANTOR CONSOLIDATING BALANCE SHEET DECEMBER 31, 1999 (IN THOUSANDS)

	KMC TELECOM HOLDINGS, INC. PARENT CO.	GUARANTOR	NON- GUARANTOR SUBSIDIARIES	ELIMINATIONS	CONSOLIDATED KMC TELECOM HOLDINGS, INC.
ASSETS					
Current assets:					
Cash and cash equivalents (overdraft).....	\$ (833)	\$ --	\$ 86,799	\$ --	\$ 85,966
Restricted investments.....	--	37,125	--	--	37,125
Accounts receivable, net.....	6	--	27,367	--	27,373
Prepaid expenses and other current assets.....	1,249	--	126	--	1,375
Amounts due from subsidiaries.....	70,872	--	(72,972)	--	--
Total current assets	70,394	37,125	41,320	--	151,839
Long-term restricted investments.....	--	51,446	--	--	51,446
Networks and equipment, net.....	58,531	--	580,793	--	639,324
Intangible assets, net.....	1,388	--	2,214	--	3,602
Deferred financing costs, net.....	21,031	--	17,785	--	38,816
Loans receivable from subsidiaries.....	590,100	(85,329)	(504,774)	--	--
Other assets.....	225	--	188	--	1,013
Total assets	\$ 745,272	\$ 3,242	\$ 137,526	\$ --	\$ 886,040
LIABILITIES, REDEEMABLE AND NONREDEEMABLE EQUITY (DEFICIENCY)					
Current liabilities:					
Accounts payable.....	\$ 40,984	\$ --	\$ 126,506	\$ --	\$ 167,490
Accrued expenses.....	14,967	--	22,080	--	37,047
Deferred revenue.....	--	--	4,309	--	4,309
Total current liabilities	55,951	--	152,895	--	208,846
Notes payable.....	--	--	235,000	--	235,000
Senior notes payable.....	275,000	--	--	--	275,000
Senior discount notes payable.....	301,137	--	--	--	301,137
Losses of subsidiaries in excess of basis.....	247,127	--	--	(247,127)	--
Total liabilities	879,215	--	387,895	(247,127)	1,019,983
Redeemable equity:					
Senior redeemable, exchangeable, PIK preferred stock:					
Series E.....	50,770	--	--	--	50,770
Series F.....	41,370	--	--	--	41,370
Redeemable cumulative convertible preferred stock:					
Series A.....	71,349	--	--	--	71,349
Series C.....	40,301	--	--	--	40,301
Redeemable common stock.....	33,755	--	--	--	33,755
Redeemable common stock warrants.....	12,925	--	--	--	12,925
Total redeemable equity	250,470	--	--	--	250,470
Nonredeemable equity (deficiency):					
Common stock.....	6	--	--	--	6
Additional paid-in capital.....	--	--	--	--	--
Unearned compensation.....	(9,163)	--	--	--	(9,163)
Accumulated deficit.....	(375,256)	--	(250,369)	247,127	(375,256)

Total nonredeemable equity (deficiency)	(384,413)	3,242	(250,369)	247,127	(384,413)
	\$ 745,272	\$ 3,242	\$ 137,526	\$ --	\$ 886,040

67

GUARANTOR/NON-GUARANTOR CONSOLIDATING STATEMENT OF OPERATIONS
YEAR ENDED DECEMBER 31, 1999
(IN THOUSANDS)

	KMC TELECOM HOLDINGS, INC. PARENT CO.	GUARANTOR	NON- GUARANTOR SUBSIDIARIES	ELIMINATIONS	CONSOLIDATED KMC TELECOM HOLDINGS, INC.
Revenue.....	\$ --	\$ --	\$ 64,352	\$ (39)	\$ 64,313
Operating expenses:					
Network operating costs.....	--	--	110,348	(39)	110,309
Selling, general and administrative.....	40,714	--	15,089	--	55,803
Stock option compensation expense.....	29,833	--	--	--	29,833
Depreciation and amortization.....	3,104	--	25,973	--	29,077
Total operating expenses.....	73,651	--	151,410	(39)	225,022
Loss from operations.....	(73,651)	--	(87,058)	--	(160,709)
Intercompany charges.....	72,972	--	(72,972)	--	--
Other expense.....	(4,297)	--	--	--	(4,297)
Interest income.....	1,872	3,242	3,587	--	8,701
Interest expense.....	(36,729)	--	(32,682)	--	(69,411)
Equity in net loss of subsidiaries.....	(185,883)	--	--	185,883	--
Net income (loss).....	(225,716)	3,242	(189,125)	185,883	(225,716)
Dividends and accretion on redeemable preferred stock.....	(81,633)	--	--	--	(81,633)
Net income (loss) applicable to common shareholders	\$ (307,349)	\$ 3,242	\$ (189,125)	\$ 185,883	\$ (307,349)

68

GUARANTOR/NON-GUARANTOR CONSOLIDATING STATEMENT OF CASH FLOWS
YEAR ENDED DECEMBER 31, 1999
(IN THOUSANDS)

	KMC TELECOM HOLDINGS, INC. PARENT CO.	GUARANTOR	NON- GUARANTOR SUBSIDIARIES	ELIMINATIONS	CONSOLIDATED KMC TELECOM HOLDINGS, INC.
OPERATING ACTIVITIES					
Net loss.....	\$ (225,716)	\$ 3,242	\$ (189,125)	\$ 185,883	\$ (225,716)
Adjustments to reconcile net loss to net cash used in operating activities:					
Equity in net loss of subsidiaries.....	185,883	--	--	(185,883)	--
Depreciation and amortization.....	3,104	--	25,973	--	29,077
Non-cash interest expense.....	36,963	--	(5,822)	--	31,141
Non-cash stock option compensation expense.....	29,833	--	--	--	29,833
Changes in assets and liabilities:					
Accounts receivable.....	(6)	--	(19,828)	--	(19,834)
Prepaid expenses and other current assets.....	(917)	--	857	--	(60)
Accounts payable.....	441	--	28,878	--	29,319
Accrued expenses.....	9,075	--	15,152	--	24,227
Amounts due from subsidiaries.....	(52,050)	--	52,050	--	--
Other assets.....	1,128	--	2,592	--	3,720
Net cash provided by (used in) operating activities.....	(12,262)	3,242	(89,273)	--	(98,293)
INVESTING ACTIVITIES					
Loans receivable from subsidiaries.....	(324,390)	85,329	239,061	--	--
Construction of networks and purchases of equipment.....	(18,327)	--	(300,209)	--	(318,536)
Acquisitions of franchises, authorizations and related assets.....	(796)	--	(1,196)	--	(1,992)
Redemption (purchase) of investments.....	--	(88,571)	27,920	104,101	43,450

Net cash used in investing activities.....	(343,513)	(3,242)	(34,424)	104,101	(277,078)
FINANCING ACTIVITIES					
Proceeds from issuance of preferred stock and related warrants, net of issuance costs.....	91,001	--	--	--	91,001
Proceeds from exercise of stock options.....	333	--	--	--	333
Proceeds from issuance of senior notes, net of issuance costs and purchase of portfolio of restricted investments.....	262,387	--	--	(104,101)	158,286
Proceeds from senior secured credit facility, net of issuance costs.....	--	--	192,836	--	192,836
Issuance costs of Lucent facility.....	--	--	(2,300)	--	(2,300)
Net cash provided by financing activities.....	353,721	--	190,536	(104,101)	440,156
Net increase (decrease) in cash and cash equivalents.....	(2,054)	--	66,839	--	64,785
Cash and cash equivalents, beginning of year.....	1,221	--	19,960	--	21,181
Cash and cash equivalents, end of year.....	\$ (833)	\$ --	\$ 86,799	\$ --	\$ 85,966

18. SUBSEQUENT EVENTS

Amended Senior Secured Credit Facility

During the first quarter of 2000, KMC Telecom, KMC Telecom II, KMC Telecom of Virginia and KMC Telecom III (the "Borrowers"), amended, restated and combined the Senior Secured Credit Facility and the Lucent Facility by entering into a \$700 million Loan and Security Agreement (the "Amended Senior Secured Credit Facility") with a group of lenders led by Newcourt Commercial Finance Corporation, GE Capital, Canadian Imperial Bank of Commerce ("CIBC"), First Union National Bank and Lucent Technologies, Inc. (the "Lenders").

69

The Amended Senior Secured Credit Facility includes a \$175 million reducing revolver facility (the "Revolver"), a \$75 million term loan (the "Term Loan") and a \$450 million term loan facility (the "Lucent Term Loan").

The Revolver will mature on April 1, 2007. Proceeds from the Revolver can be used to finance the purchase of certain equipment, transaction costs and, upon attainment of certain financial conditions, for working capital and other general corporate purposes. The aggregate commitment of the Lenders under the Revolver will be reduced on each payment date beginning April 1, 2003. The initial quarterly commitment reduction is 5.0%, reducing to 3.75% on July 1, 2003 and increasing to 6.25% on July 1, 2004, and further increasing to 7.50% on July 1, 2006. Commencing with the fiscal year ending December 31, 2001, the aggregate Revolver commitment will be further reduced by an amount equal to 50% of excess operating cash flows (as defined in the Facility) for the prior fiscal year until the Borrowers achieve certain financial conditions. The Borrowers must pay an annual commitment fee on the unused portion of the Revolver ranging from .75% to 1.25%.

The Term Loan is payable in twenty consecutive quarterly installments of \$188,000 beginning on April 1, 2002 and two final installments of \$35.6 million each on April 1, 2007 and July 1, 2007. Proceeds from the Term Loan can be used to finance the purchase of certain equipment, transaction costs, working capital and other general corporate purposes.

The Lucent Term Loan provides for an aggregate commitment of up to \$450 million. Proceeds from the Lucent Term Loan can be used to purchase Lucent products or to reimburse the Borrowers for Lucent products previously purchased with cash or other sources of liquidity. The Lucent Term Loan will mature on July 1, 2007 and has required quarterly amortization beginning on July 1, 2003 of 5%. The amortization decreases to 3.75% per quarter beginning on October 1, 2003, increases to 6.25% on October 1, 2004 and further increases to 7.50% on October 1, 2006. An annual commitment fee of 1.50% is payable for any unused portion of the Lucent Term Loan.

The Amended Senior Secured Credit Facility will bear interest payable at the Borrowers' option, at (a) the "Applicable Base Rate Margin" (which generally

ranges from 2.00% to 3.25% plus the greater of (i) the administrative agent's prime rate or (ii) the overnight federal funds rate plus .5% or (b) the "Applicable LIBOR Margin" (which generally ranges from 3.00% to 4.25%) plus LIBOR, as defined. "Applicable Base Rate Margin" interest is payable quarterly while "Applicable LIBOR Margin" interest is payable at the end of each applicable interest period or at least every three months. If a payment default were to occur, the interest rate will be increased by four percentage points. If any other event of default shall occur, the interest rate will be increased by two percentage points.

KMC Holdings has unconditionally guaranteed the repayment of the Amended Senior Secured Credit Facility when such repayment is due, whether at maturity, upon acceleration, or otherwise. KMC Holdings has pledged the shares of each of the Borrowers to the Lenders to collateralize its obligations under the guaranty. In addition, the Borrowers have each pledged all of their assets to the Lenders.

The Amended Senior Secured Credit Facility contains a number of affirmative and negative covenants, including a covenant requiring the Borrowers to obtain cash capital contributions from KMC Holdings of at least \$185 million prior to April 1, 2001. KMC Holdings has secured a financing commitment from Lucent for \$100 million in PIK Preferred Stock towards this requirement and currently contemplates raising the \$85 million balance through private or public sales of securities in the capital markets. Additional affirmative and negative covenants include, among others, restricting the ability of the Borrowers to consolidate or merge with any person, sell or lease assets not in the ordinary course of business, sell or enter into long term leases of dark fiber, redeem stock, pay dividends or make any other payments (including payments of principal or interest on loans) to KMC Holdings, create subsidiaries, transfer any permits or licenses, or incur additional indebtedness or act as guarantor for the debt of any person, subject to certain conditions.

The Borrowers are required to comply with certain financial tests and maintain certain financial ratios, including, among others, a ratio of total debt to contributed capital, certain minimum revenues, maximum EBITDA losses and minimum EBITDA, maximum capital expenditures and minimum access lines, a maximum total leverage ratio, a minimum debt service coverage ratio, a minimum fixed charge coverage ratio and a maximum consolidated leverage ratio. The covenants become more restrictive upon the earlier of (i) March 31, 2002 and (ii) after the Borrowers achieve positive EBITDA on a combined basis for two consecutive fiscal quarters and a total leverage ratio (as defined) equal to or less than 8 to 1.

70

Failure to satisfy any of the financial covenants will constitute an event of default under the Amended Senior Secured Credit Facility permitting the Lenders, after notice, to terminate the commitment and/or accelerate payment of outstanding indebtedness. The Amended Senior Secured Credit Facility also includes other customary events of default, including, without limitation, a cross-default to other material indebtedness, material undischarged judgments, bankruptcy, loss of a material franchise or material license, breach of representations and warranties, a material adverse change, and the occurrence of a change of control.

71

Independent Auditors' Report on Schedules

The Board of Directors and Stockholders

Copyright 2000 EDGAR Online, Inc. (ver 1.01/2.003)

Page 73

DC01/JENKE/110003.1

KMC Telecom Holdings, Inc.

We have audited the consolidated balance sheets of KMC Telecom Holdings, Inc. as of December 31, 1998 and 1999 and the related consolidated statements of operations, redeemable and nonredeemable equity and cash flows for the years then ended. Our audit report issued thereon dated January 31, 2000, except for Note 18, as to which the date is March 28, 2000, is included elsewhere in this Form 10-K. Our audit also included the financial statement schedules listed in Item 14(a) of this Form 10-K. These schedules are the responsibility of the Company's management. Our responsibility is to express an opinion based on our audits.

In our opinion, the financial statement schedules referred to above, when considered in relation to the basic financial statements taken as a whole, present fairly, in all material respects the information set forth therein.

/s/ ERNST & YOUNG LLP

MetroPark, New Jersey
January 31, 2000, except for Note 8,
as to which the date is March 28, 2000

72

SCHEDULE I - Condensed Financial Information of Registrant

KMC Telecom Holdings, Inc. (Parent Company)

Condensed Balance Sheets (in thousands)

	DECEMBER 31	
	1998	1999
ASSETS		
Current assets:		
Cash and cash equivalents (overdraft).....	\$ 1,221	\$ (833)
Amounts due from subsidiaries.....	20,922	72,972
Prepaid expenses and other current assets.....	332	1,255
Total current assets.....	22,475	73,394
Loans receivable from subsidiaries.....	265,713	590,103
Networks and equipment, net.....	4,775	58,531
Intangible assets, net.....	625	1,388
Deferred financing costs.....	12,055	21,031
Other assets.....	1,952	825
	<u>\$307,595</u>	<u>\$745,272</u>
LIABILITIES, REDEEMABLE AND NONREDEEMABLE EQUITY (DEFICIENCY)		
Current liabilities:		
Accounts payable.....	\$ 2,043	\$ 40,984
Accrued expenses.....	5,838	14,967
Total current liabilities.....	7,881	55,951
Senior notes payable.....	--	275,000
Senior discount notes payable.....	267,811	301,137
Losses of subsidiaries in excess of basis.....	61,244	247,127
Total liabilities.....	<u>336,936</u>	<u>879,215</u>
Redeemable equity:		
Senior redeemable, exchangeable, PIK preferred stock, par value \$0.01 per share; authorized: -0- shares in 1998 and 630 shares in 1999; shares issued and outstanding:		
Series E, -0- in 1998 and 65 shares in 1999 (\$65,004 liquidation preference).....	--	50,770
Series F, -0- in 1998 and 44 shares in 1999 (\$44,177 liquidation preference).....	--	41,370

Redeemable cumulative convertible preferred stock, par value \$0.01 per share; 499 shares authorized; shares issued and outstanding:		
Series A, 124 shares in 1998 and 1999 (\$12,380 liquidation preference)...	30,390	71,349
Series C, 175 shares in 1998 and 1999 (\$17,500 liquidation preference)...	21,643	40,301
Redeemable common stock, shares issued and outstanding, 224 in 1998 and in 1999.....	22,305	33,755
Redeemable common stock warrants.....	674	12,925
Total redeemable equity.....	75,012	250,470
Nonredeemable equity (deficiency):		
Common stock, par value \$0.01 per share, 3,000 shares authorized; shares issued and outstanding: 614 shares in 1998 and 629 shares in 1999.....	6	6
Additional paid-in capital.....	13,750	--
Unearned compensation.....	(5,824)	(9,163)
Accumulated deficit.....	(112,285)	(375,256)
Total nonredeemable equity (deficiency).....	(104,353)	(384,413)
	\$307,595	\$745,272
	*****	*****

See accompanying notes.

73

KMC Telecom Holdings, Inc.
(Parent Company)

Condensed Statements of Operations
(in thousands)

	SEPTEMBER 22, 1997 (FORMATION) TO DECEMBER 31, 1997	YEAR ENDED DECEMBER 31	
		1998	1999
Operating expenses:			
Selling, general and administrative.....	\$ --	\$ 19,624	\$ 40,714
Stock option compensation expense.....	--	21,190	29,833
Depreciation and amortization.....	--	1,197	3,104
Total operating expenses.....	--	42,011	73,651
Loss from operations.....	--	(42,011)	(73,651)
Other expense.....	--	--	(4,297)
Intercompany charges.....	--	20,922	72,972
Interest income.....	--	8,575	1,872
Interest expense.....	--	(23,104)	(36,729)
Equity in net loss of subsidiaries.....	(21,860)	(41,135)	(185,883)
Net loss.....	(21,860)	(76,753)	(225,716)
Dividends and accretion on redeemable preferred stock.....	(8,904)	(18,295)	(81,633)
Net loss applicable to common shareholders.....	\$(30,764)	\$(95,038)	\$(307,349)
	*****	*****	*****

See accompanying notes.

74

KMC Telecom Holdings, Inc.
(Parent Company)

Condensed Statements of Cash Flows
(in thousands)